8/21/87 B5350-3

MANUFACTURERS HANOVER

Economic Report

July 1987

Commentary on Pertinent Economic Issues

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Business Conditions Update

Summer 1987 finds the U.S. economy approaching another milestone. July marks the 56th month that the economy as a whole has been expanding. This is only two months shy of the all-time record for a peacetime upswing, which was set in the late 1970s. There is little doubt that this record will fall come October, since virtually all economists expect business to continue growing for the rest of this year.

Despite Numerous Negatives . . .

The reader should be aware that these forecasts of continued economic growth are being made in the face of a number of uncertainties. The first is the age of the expansion itself. Trees don't grow to the sky, and people don't live forever. Since records were first kept in the mid-1800s, the U.S. has experienced 30 recessions, averaging 18 months in duration (eleven months since the end of the Second World War). Because the current upswing is now two-thirds longer than the average postwar peacetime expansion, one has to keep in mind that the probabilities of the expansion coming to a halt are clearly greater today than they were a year ago–not to mention in 1985.

Then there is the trade deficit. True, it has receded from its high point reached in the third quarter of 1986: According to the government's preliminary estimates of the second-quarter gross national product, our foreign trade deficit, adjusted for inflation, is now $34 billion, or 21 percent, lower than it was at its peak in the third quarter of 1986. However, this brings the trade deficit only back to where it was in the first quarter of 1986 – and that still represents a substantial drain from the goods-producing sector of the economy. It also represents another addition to our foreign debt–which at the end of last year amounted to $264 billion, 2½ times the debt burden of Brazil, the world's second-largest debtor.

Tax reform is another question mark. The new tax law has had several effects on the economy. First, it distorted the economic statistics by encouraging consumers to shift forward their planned expenditures on big-ticket items from 1987 to yearend 1986 in order to capture the sales tax deduction that was eliminated on January 1 of this year. This rush of spending late last year caused business inventories to drop by the largest amount since the end of the last recession. As a result, the gross national product in 1986's fourth quarter grew only one third as fast as it would have, had inventories held steady.

This surge in demand led some economists and businessmen to conclude that the economy was speeding up. Not surprisingly, production schedules were maintained or even increased early this year and inventories were rebuilt. However, and also not surprisingly, demand subsequently diminished and, as a result, all of the growth that took place in this year's first quarter, and then some, traced to inventory accumulation. This decline in sales caused other economists to think that the economy was slowing down–if not going into reverse. The second quarter's figures, showing somewhat less inventory accumulation but a resumption of growth in demand, were probably more indicative of the underlying trends during the previous six months. Tax reform also managed to cut into business spending, especially for structures. Outlays in the second quarter were 18 percent below the levels reached in the fourth quarter of 1985, after adjusting for higher prices.

Another uncertainty is the status of Washington's budget deficit. To be sure, it looks very good for the current fiscal year. Three-fourths of the way through fiscal year 1987, Washington's budget deficit appears to have shrunk considerably from last year's record. To the extent that spending and revenue trends for nine months can be extrapolated to a full year, the deficit is running at an annual rate of $158 billion in FY 1987, $63 billion, or nearly 30 percent, below last year's $221 billion. However, this is not as good as it seems. For one thing, it is still far above the Gramm-Rudman target for the current fiscal year of $144 billion. For another, most of the decline is believed to be a one-time result of the enactment of the tax reform law. Other than people in the Administration, virtually no one is expecting the deficit in FY 1988 to decline from current

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levels. And while a deficit in Washington's budget does impart stimulus to the economy, it also puts pressures on the financial markets by increasing Washington's demands for funds, thereby keeping interest rates higher than they otherwise would be.

If these developments were not enough, there have recently appeared a number of signs that in the past have signaled the onset of recession:

- *An acceleration of inflation.* After falling at a 1½ percent annual rate in 1986's second quarter, prices at the consumer level shot up at a 5½ percent clip in the first six months of this year. That's the fastest six-month rate of rise in almost five years. What is more, producer prices of intermediate materials excluding food and energy have been accelerating. From a decline of 1½ percent at an annual rate a year ago, these goods rose at a 0.8 percent clip in last year's third quarter, 1.5 percent in the fourth, 2.7 percent in 1987's first quarter, and 3.5 percent in the second. And at the earliest stage of production, prices of industrial raw materials have shot up by nearly 25 percent over the past year. Needless to say, prices of imported goods are up sharply, reflecting the decline in the dollar, while the price of oil in spot markets is more than double its low point of April 1986.

- *Rising interest rates.* Since touching bottom in autumn 1986, money-market interest rates have risen by about one percentage point, prompting the nation's commercial banks to increase their prime lending rates by ¾ of one percentage point. Long-term yields have advanced even more–and in a shorter period of time. A tightening of monetary policy by the Federal Reserve, along with increased concerns in the markets about inflation, appears to be responsible.

- *A jittery stock market.* Its rapid runup so far this year, combined with the increase in interest rates and the drop in the dollar, has made many investors leery of further commitments to equities.

- *Fewer domestic car sales.* New auto purchases so far this year have declined considerably. After running at a tax reform-induced rate of 9.7 million units in 1986's third quarter, the pace of new domestic auto sales slumped to seven million in this year's second quarter. For the first six months of this year, they are down ten percent from 1986's comparable period–and are 15 percent lower than they were during the same time in 1985. June's sales were the lowest for the month in five years.

- *Less residential construction.* In the wake of sharply higher mortgage interest rates and higher prices, housing starts have fallen for four months in a row, a development that last occurred prior to the 1981-82 recession. So far this year, the rate of new-home construction is 11 percent below the same period of 1986. June's new-home starts were the lowest for any month in three years.

. . . We Should Avoid A 1987 Recession . . .

In the past, when autos and housing were falling, the U.S. economy soon lapsed into recession. This is because these two industries directly and indirectly account for a big chunk of the gross national product and a substantial number of jobs. However, this time around the U.S. should be able to avoid a recession–at least in 1987. The key to this cautious optimism lies in what has already taken place in the foreign exchange markets and its impact on our trade deficit.

July, 1987
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual Projected >											
	1986				YEAR 1986		1987				YEAR 1987	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	4174.4	4211.6	4265.9	4288.1	4235.0	5.6	4377.7	4448.8	4541.7	4639.8	4502.0	6.3
GNP: $82	3698.8	3704.7	3718.0	3731.5	3713.3	2.9	3772.2	3796.4	3823.3	3849.9	3810.5	2.6
% Change, Annual Rates	5.4	0.6	1.4	1.5	2.9		4.4	2.6	2.9	2.8	2.6	
Consumption $82	2409.8	2434.3	2477.5	2480.4	2450.5	4.2	2476.0	2488.7	2508.6	2525.3	2499.7	2.0
Durables $82	359.8	369.6	405.5	399.0	383.5	8.7	375.9	386.2	385.4	386.3	383.5	0.0
Non-Durables $82	868.8	880.0	879.8	880.3	877.2	3.3	883.2	873.6	885.5	892.8	883.8	0.7
Services $82	1181.2	1184.7	1192.2	1201.1	1189.8	3.4	1216.9	1228.9	1237.7	1246.2	1232.4	3.6
Investment $82	674.4	665.6	644.9	631.0	654.0	2.8	671.8	673.4	668.1	668.4	670.4	2.5
Non-Residential $82	453.2	441.0	437.7	443.2	443.8	−2.3	426.0	434.2	445.3	451.9	439.3	−1.0
Producers Durable Equip. $82	307.8	312.6	315.0	318.6	313.5	2.9	305.6	314.1	324.1	329.6	318.3	1.5
Structures $82	145.4	128.4	122.7	124.6	130.3	−12.8	120.4	120.2	121.2	122.3	121.0	−7.1
Residential $82	185.9	196.5	201.1	202.2	196.4	12.5	198.2	198.0	196.4	194.3	196.7	0.2
Inventory Changes $82	35.3	28.1	6.1	−14.4	13.8		47.6	41.2	26.4	22.1	34.3	
Net Exports $82	−122.9	−146.8	−161.6	−151.8	−145.8		−135.2	−127.8	−122.9	−121.0	−126.7	
Government Purchases $82	737.5	751.5	757.2	771.7	754.5	3.8	759.6	762.2	769.6	777.2	767.2	1.7
Federal Defense $82	240.0	250.1	259.8	252.7	250.6	5.9	257.4	262.4	256.9	256.0	258.2	3.0
Federal Civilian $82	82.0	80.4	72.8	91.9	81.8	−6.5	69.9	63.9	74.1	80.7	72.2	−11.8
State & Local $82	415.5	421.0	424.6	427.1	422.0	4.8	432.3	435.9	438.6	440.6	436.8	3.5
Final Sales: $82	3663.5	3676.6	3711.9	3745.9	3699.5	2.8	3724.6	3755.2	3796.9	3827.8	3776.1	2.1
% Change, Annual Rates	1.2	1.4	3.9	3.7	2.8		−2.3	3.3	4.5	3.3	2.1	
Domestic Demand: $82	3821.7	3851.5	3879.6	3883.3	3859.0	3.9	3907.4	3924.2	3946.3	3970.9	3937.2	2.0
% Change, Annual Rates	4.5	3.2	3.0	0.4	3.9		2.5	1.7	2.3	2.5	2.0	
GNP Price Index (1982 = 100)	112.9	113.7	114.7	114.9	114.0	2.6	116.1	117.2	118.8	120.5	118.2	3.6
% Change, Annual Rates	1.8	2.9	3.6	0.7	2.6		4.2	3.8	5.5	5.9	3.6	
Consumer Price Index (1967 = 100)	327.7	326.6	328.6	330.7	328.4	1.9	335.0	339.0	343.6	348.4	341.5	4.0
% Change, Annual Rates	1.6	−1.3	2.4	2.7	1.9		5.3	4.9	5.5	5.7	4.0	
Total Personal Income	3463.4	3526.6	3553.6	3593.6	3534.3	6.2	3662.0	3716.4	3735.5	3823.0	3734.2	5.7
Disposable Personal Income	2966.0	3022.4	3038.2	3061.6	3022.0	6.4	3125.9	3138.5	3196.4	3269.5	3182.6	5.3
Savings Rate (%)	4.7	5.5	3.6	3.6	4.3		4.4	3.2	3.3	3.7	3.6	
Unemployment Rate (%)	7.1	7.1	6.9	6.8	7.0		6.7	6.2	6.0	5.9	6.2	
Indus. Production (1977 = 100)	125.0	124.4	125.0	126.0	125.1	1.0	127.0	127.8	130.3	131.3	129.1	3.2
Housing Starts (000)	1938.0	1878.3	1758.3	1702.3	1819.3	4.4	1794.7	1611.7	1695.1	1669.8	1692.8	−7.0
Domestic Auto Sales (000)	7837.0	8144.7	9699.7	7876.7	8389.5	2.3	6786.7	7007.9	7382.1	6933.9	7027.6	−16.2
Corporate Pre-Tax Profits	222.5	227.7	240.4	259.6	237.5	6.5	267.6	258.9	283.5	285.5	273.9	15.3
−Taxes	95.6	98.9	104.5	115.1	103.5		128.8	121.4	133.6	137.4	130.3	
Net Profits	126.9	128.8	135.9	144.5	134.0	2.0	138.8	137.5	149.9	148.1	143.6	7.1
−Dividend Payments	85.2	87.5	88.8	89.7	87.8	7.6	91.4	93.9	96.1	98.4	95.0	8.2
Undistributed Profits	41.7	41.3	47.1	54.8	46.2	−7.1	47.4	43.6	53.8	49.6	48.6	5.2
+Depreciation	332.6	333.7	337.1	344.3	336.9		362.0	364.0	367.1	371.3	366.1	
−Inventory Profits	−16.5	−10.6	−6.1	7.2	−6.5		6.9	9.4	11.6	12.7	10.2	
Net Cash Flow	390.8	385.6	390.3	391.9	389.6	3.8	402.5	398.1	409.4	408.1	404.5	3.8

As you know, the dollar has dropped significantly against a number of key currencies since reaching a peak back in February 1985. In less than 2½ years, the dollar has fallen by about 42 percent against the Japanese yen and German mark, around 40 percent against the French and Belgian francs and the Dutch guilder, and more than 30 percent against the British pound and the Italian lira. Although these countries represent less than 48 percent of our bilateral trade, the rise in their currencies against the dollar was substantial enough to turn the tide in our trade deficit.

Demand for U.S.-made goods is once more climbing. In the last three calendar quarters, the shrinkage in our foreign trade deficit has added about one percentage point to economic growth, whereas in the previous three quarters the widening of the trade deficit subtracted about one percentage point.

. . . But No Guarantees For 1988

While the trade deficit is expected to shrink further, there are some questions regarding how much longer it can help keep the economy afloat. For one thing, the dollar has strengthened somewhat against the major currencies since bottoming out in the spring. For another, as observed above, the countries against whose currencies the dollar has fallen markedly represent less than half of our two-way trade. Against the currencies of many other countries–including Canada, our largest trading partner–the dollar has fallen very little since early 1985, and in some cases has actually increased.

The Manufacturers Hanover trade-weighted dollar (Economic Report–September 1986) takes this broader array of countries into account. When compared with the currencies of the countries with which we do 80 percent of our trade, the dollar has fallen by less than 10 percent before adjusting for inflation, and less than three percent in real terms. By contrast, the Federal Reserve's measure shows a drop of about 40 percent. It would appear that, unless the dollar falls further–especially against the currencies where it hasn't fallen all that much–the U.S. trade deficit will not decline as fast as needed to keep us out of recession.

Keep in mind that domestic demand grew only two-fifths as much in the last three quarters as it did in the previous three; it is likely to grow even more slowly in the months ahead because of the negative effects arising from more inflation (less buying power), higher interest rates (less borrowing power) and a jittery stock market (less confidence). If the trade deficit fails to decline enough to offset this weakness in demand, there will be nothing left to keep us out of recession.

While 1988 is a presidential election year, it doesn't automatically guarantee that the economy will continue to grow. It may be unusual for us to encounter a recession during a year divisible by four–but it is not unprecedented. The U.S. economy was in recession from January until July 1980, and before that, from April 1960 until February 1961. In both of these presidential election years, the party that occupied the White House was subsequently forced by the voters to vacate.

The selection of Alan Greenspan to replace Paul Volcker as Chairman of the Federal Reserve Board has been interpreted by some as a reason to expect continued economic growth in 1988. In fact, it may do just the opposite. To establish the credibility his predecessor already has, Mr. Greenspan may have to push up interest rates faster than Mr. Volcker would have to keep the dollar stable and contain inflation psychology. ■

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Performance

American-Italian Pasta Company
a joint venture between
Richard Thompson and FinPetrini S.p.A.
$22,233,000
13-month construction loan converting to a 5-year term loan
for a
Durum Wheat Mill and Pasta Production Facility
The CIT Group/Equipment Financing's Project Finance Division structured and provided the financing for the above transaction.
Comdisco, Inc.
$10,000,000
Debt Funding on Lease Transactions
for
Data Processing Equipment
The CIT Group/Equipment Financing's Chicago office provided the financing for the above transaction.
Affiliated Food Stores, Inc.
$8,613,000
Leveraged Lease
for
Tractors and Trailers
The CIT Group/Equipment Financing's Boston office provided the debt financing for the above transaction with American Finance Group, Inc. as lessor.
Appalachian Regional Healthcare, Inc.
$4,747,000
Loan and Security Agreement
for
Medical Equipment
The CIT Group/Equipment Financing's Cleveland office provided the debt financing for the above leveraged lease with Financial Investments Associates, Inc. as lessor.
Carlisle Construction Company, Inc.
$4,300,000
Line of Credit
for
Cranes and Excavating Equipment
The CIT Group/Equipment Financing's Columbus office structured and provided the financing for the above transaction.
Aircraft Trading Center (A.T.C.)
$2,600,000
Loan Agreement
for
Corporate Aircraft
The CIT Group/Equipment Financing's Miami office structured and provided the financing for the above transaction.

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